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Small-Caps Are Poised to Climb, Baron Manager Says

Randy Gwirtzman, co-manager of Baron Discovery Fund, shares his favorite small-cap stocks and industries.

DAN WEIL · JUL 1, 2023

Randy Gwirtzman, co-manager of Baron Discovery Fund Baron Funds

Small-capitalization stocks have lagged large-caps over the past 10 years. But little brother is poised for a recovery, says Randy Gwirtzman, co-manager of Baron Discovery Fund, composed of small-cap growth stocks.

As of June 29, the fund generated annualized returns of 12.78% for the past year, 5.41% for the past three years and 7.1% for the past five years, according to Morningstar. That compares with 16.28%, 7.59% and 4.54% for Morningstar's small-cap growth-stock index.

From its inception Sept. 30, 2013, through May 31, the fund returned 11.35% annualized, almost twice the 6.92% of the Russell 2000 Growth Index of small-cap stocks, according to Baron.

We recently chatted with Gwirtzman about his views of the small-cap market, including which industries he favors and a couple of his stock picks. Here are his comments.

TheStreet.com: *What's your investment philosophy?*
Gwirtzman: We're looking for secular, not cyclical, investments. We believe in long-term market inefficiencies. We look for companies with sustainable advantages. We're looking for companies that can double their share price in five years, which means gains of about 15% annualized.

We want companies that haven't deeply penetrated their markets, so there is a lot of room for them to grow. From a risk management perspective, we are careful about position size, valuations and industry allocation versus the Russell 2000 Growth index.

TheStreet.com: *What makes small-cap attractive as an asset class?*
Gwirtzman: There are a lot more inefficiencies in small-cap versus the others. Fewer people doing the work

[research]. The companies are often misunderstood. Their market penetration tends to be low. Our tagline about small-cap companies is "you've never heard of them, but you will." These are companies that could be the next Apple or Nvidia.

TheStreet.com: *What's your outlook for small-cap growth stocks near-term and long-term?*

It feels like the Fed is closer to ending its tightening. Inflation is coming down quite a bit. Earnings estimates are coming down. We think unemployment will rise. Small-caps are priced for mild recession.

They are underpriced versus large-cap. The forward enterprise value-to-Ebitda ratio stands at 12.5 for small-cap versus 13.5 for large-cap. It's typical for the small-cap ratio to be above large-cap.

Small-cap generally leads the market down going into recession and leads it up coming out of recession. Once investors get convinced we're near the end of recession, stocks will likely anticipate that. Small-cap is in really good shape to outperform over the next six to 12 months.

This is an incredibly attractive asset class over the long term. There are great companies with organic growth. When you're smaller, it's easier to grow faster.

TheStreet.com: *What industries are attractive for small-cap growth stocks now?*

Gwirtzman: 1. Software. That includes cybersecurity, database software and application development software. In 2022, small-cap software stocks were inordinately hurt. There are great secular growth opportunities in the sector. The stocks also are at valuations we haven't seen for a long time. You're getting high-quality companies at bargain prices.

2. Semiconductors: analog chips used in auto end markets and power management. In autos, more efficient chips can be used throughout the vehicle, preserving battery power and increasing range in electric vehicles. As for power management, efficient chips can save energy in data centers and elsewhere.

3. Industrials: ones with protected high-end markets, such as defense.

4. Health Care: There are good opportunities, but you have to be careful picking individual companies. Valuations have held up better than other stocks in the market downturn. That's because health care is less affected by the economic cycle.

TheStreet.com: *Can you discuss two of your favorite stocks?*

1. Indie Semiconductor. It produces semiconductors used in auto end markets. It designs mixed-signal chips They're used for safety systems, power management and back-end user experiences, such as integrating your phone with the dashboard display.

They have sole-sourced contracts that last seven to 10 years. They will likely double their revenue in 2023 and can multiply their revenue by four over the next five years. The stock could go to $30 in 2027. [It recently traded at $9.35.]

2. Axonics. They make medical devices for incontinence. They have a terrific balance sheet, with no debt.

They have an implantable device like a pacemaker to combat urge incontinence, which occurs when you can't control your bodily functions. The device sends pulses, which improve the patient's situation.

There's also stress incontinence, where physical force causes leakage of the bladder. This happens a lot to women post-childbirth. Some have such an issue that surgery is necessary. Axonics has an injectable drug, Bulkamid, that treats stress continence without surgery. This could be a $2 billion to $3 billion drug [in sales per year.]

Axonics' revenue will likely average 25% growth over the next five years, and the stock could rise to $140. [It recently traded at $50.70.]

Baron Discovery Fund's annualized returns for the Institutional Shares as of 6/30/2023: 1-year, 15.44%; 5-year, 7.58%; since inception (9/30/2013), 12.38%. The annual expense ratio for the Institutional Shares as of September 30, 2022 was 1.06%.

The Russell 2000 Growth Index's annualized returns as of 6/30/2023: 1-year, 18.53%; 5-year, 4.22%; since fund inception (9/30/2013), 7.73%.

The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser may reimburse certain Fund expenses pursuant to a contract expiring on August 29, 2033, unless renewed for another 11-year term and the Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

The Fund's 3- and 5-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

Risks: Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns.

Portfolio holdings as a percentage of net assets as of June 30, 2023 for securities mentioned are as follows: indie Semiconductor – (2.0)%; Axonics, Inc. – (2.4)%.

Baron Discovery Fund
Top 10 Holdings
As of 6/30/2023

Holding	% Holding
Kinsale Capital Group, Inc.	5
Boyd Gaming Corporation	3.8
Advanced Energy Industries, Inc.	3.5
GitLab Inc.	3.4
Floor & Decor Holdings, Inc.	2.9
SiteOne Landscape Supply, Inc.	2.9
Chart Industries, Inc.	2.7
Rexford Industrial Realty, Inc.	2.5
Montrose Environmental Group, Inc.	2.4
Axon Enterprise, Inc.	2.4
Total	31.5

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth. All rights in the FTSE Russell Index (the "Index") vest in the relevant LSE Group company which owns the Index. Russell® is a trade mark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. The Fund includes reinvestment of dividends, net of withholding taxes, while the **Russell 2000® Growth Index** includes reinvestment of dividends before taxes. Reinvestment of dividends positively impacts the performance results. The index is unmanaged. Index performance is not Fund performance. Investors cannot invest directly in an index.

Enterprise value (EV) is a measure of a company's total value, often used as a more comprehensive alternative to equity market capitalization. EV includes in its calculation the market capitalization of a company but also short-term and long-term debt as well as any cash on the company's balance sheet.

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